

**Investigation by the Department of Telecommunications and Energy into its own Motion into the Procurement of Default Service Power Supply for Residential and Small Commercial and Industrial Customers**

Reply Comments of the Union of Concerned Scientists, Massachusetts Public Interest Research Group, Massachusetts Energy Consumers Alliance, Clean Water Action, and the Conservation Law Foundation

January 26, 2005

We welcome the opportunity to submit the following reply comments to the Department of Telecommunications and Energy (“Department” or “DTE”) regarding the procurement of default service power in Massachusetts. These comments are submitted by the Union of Concerned Scientists, Massachusetts Public Interest Research Group, Massachusetts Energy Consumers Alliance, Conservation Law Foundation, and Clean Water Action Alliance of Massachusetts.

**Executive Summary**

In our reply comments, we respond to issues raised by other commenters and in our previous comments on:

- the need for the Department to address the significant shortcomings of default service procurement
- the lack of attention to Renewable Portfolio Standard (RPS) compliance as an important component of default service procurement;
- the importance of long term contracts for renewable procurement;
- the insignificant risks associated with long-term renewable energy contracts – relative to the much greater risks of relying solely on short-term contracts;
- the unique advantages of long-term contracts with renewable energy generators;
- the need for transparency in renewable energy and certificate procurement for RPS compliance; and
- the role of long-term renewable energy procurement in a statewide procurement process.

Clearly, current default service procurement policy is failing to produce the results that will lead to reasonable RPS compliance costs. The costs associated with this failure include a lack of renewable energy resource development in the region and unnecessarily high RPS compliance costs.

Our initial comments describe in detail the current circumstances and the implications for continued failure in this area of procurement. To address the problems identified in our initial comments, we recommend that the DTE issue an order that:

- recognizes that a significant number of small customers will remain on default service for the foreseeable future
- ensures the same transparency for procurement for RPS compliance for default service as is required for default service procurement more generally;
- requires default service providers to report annually on their prospective RPS compliance plans, including a quantitative demonstration regarding the appropriateness of their compliance approach, plus quarterly progress reports that demonstrate progress toward meeting RPS targets; and
- requires that default service providers use long-term contracts to purchase renewable energy and certificates in amounts that match *at least* their incremental RPS compliance target for the current year.

**I. Through this proceeding, the Department must address several significant failures of the current default service procurement policy**

In the initial comments on this proceeding, several commenters (including DOER at 5, MA AG at 1, and NSTAR at 2) describe the two main goals of default service procurement as resulting in service that reflects current electricity market prices and the provision of reasonably priced, stable service. We agree that it is important the Department of Telecommunications and Energy (the Department or DTE) to strike a balance between these two goals. However, current department policy on default service procurement is failing to:

- protect captive ratepayers from price volatility,
- prevent excessive default service rates and cross subsidization, and
- ensure state energy and environmental goals are achieved.

In addressing these failures, we call upon the Department to implement policy solutions that achieve the highest possible ratepayer, reliability, and environmental value. One solution that directly addresses the current failures of procurement and brings a range of valuable benefits to customers is long-term contracts for renewable energy.

***Failure 1. Protecting captive ratepayers from price volatility***

While some commenters think that competition for small customers may eventually emerge, the DTE plan for default service must be robust enough to carry captive customers through a transition that may be lengthy. As of now, there is no experience from other jurisdictions to indicate that the transition will be short. Indeed, even some of the strongest restructuring and free market advocates, like most of National Commission on Energy Policy and the Cato Institute, have concluded that competition for small customers may not emerge. The DTE's plan must be designed to protect captive customers in the event that the transition to competition is lengthy or does not take place at all.

As we pointed out in our initial comments, a balanced portfolio that minimizes risks should include a component that locks in long-term stable prices, insulated from fossil fuel price swings and the prospect of long-term price increases. At this time, natural gas supply for New England is precarious, with the very strong likelihood of higher and more volatile prices. While it is certainly possible that the United States will experience a substantial increase in LNG capacity,

and the development of an Alaskan pipeline may eventually moderate gas prices, it is also quite possible that there will be lengthy delays in such projects that will cause gas prices to remain at high levels for an extended period.

A balanced procurement approach would have at least a small part of the portfolio positioned to hedge against that risk. Here, we are asking that, at a minimum, the very small part of the portfolio that by law must be filled by renewable generation in any case (increasing at an increment of 0.5% of sales each year), be utilized for that purpose, by requiring long-term contracts for that part of the portfolio.

We understand that in discussions of long-term commitments, there is always a lingering fear of stranded costs, such as those that resulted from acquisitions under PURPA. PURPA required that the price of all new supply acquisitions be locked in with 30-year contracts. Here we are recommending the DTE require very small percentage of new supply acquisitions (0.5% each year, 4% total by 2009) to have stable contract prices for at least 10 years. Prudent hedging in a balanced portfolio might well call for higher amounts of stable-price long-term contracts. The Department would be extremely conservative if it required long-term contracts only for the RPS-compliant portion of default service portfolios. We believe that greater levels of long-term renewable energy procurement would be even more desirable.

### ***Failure 2. Preventing excessive default service rates and cross subsidization***

As addressed in our initial comments, under current trends, default service customers will be paying 4-5 cents per kilowatt-hour for renewable energy certificates (RECs) that can be obtained under long-term contracts for 2-2.5 cents. Allowing this situation to continue only institutionalizes imprudent procurement practices that will cost default service customers much more than necessary. Worse, those excessive short-term credit prices paid by default service providers create a cross-subsidy where captive customers pay unnecessary high costs for renewable energy credits, while municipal customers, who are not obligated under the RPS, get the benefits of inexpensive, subsidized long-term contracts for renewable energy.

By enacting the Renewable Portfolio Standard, the legislature intended not only to help the Commonwealth meet critical environmental goals, but also to realize the fuel diversity and price stability benefits of renewable energy. Surely the legislature did not intend for captive default service customers to subsidize acquiring those benefits for non-regulated municipal customers because their utilities are implementing it in the least efficient, least equitable way possible.

### ***Failure 3. Ensuring state energy and environmental goals are achieved***

In 1997, the Massachusetts Legislature made an historic decision regarding the necessity of new renewable electricity generating resources to benefit Massachusetts electricity customers by enacting the Renewable Portfolio Standard. More recently, Governor Romney reinforced this fundamental commitment to renewable energy with the release of the state's Climate Protection Plan. The entire state government, including the Department, has been directed to participate in implementing the policies that will create an environment where significant new renewable generating resources are built. We believe that, at a minimum, policy decisions about default

service procurement must also be consistent with sound environmental, energy, public health, and climate policies.

To date, unfortunately, we believe that the promises of new energy policy and climate protection remain hollow and unmet. In particular, the failure of state government in general and the Department in particular to foster the development of renewable resources through its policies has been part of the cycle of failure. The Department must recognize that long-term contracts are needed for new renewable generation sources to be built. In our recommendations included here and in our initial comments, we call on the Department to address the failures of the current default service procurement practices to deliver the renewable energy and energy efficiency results that consumers require and deserve, and in doing so, change the course of failure and become part of the solution.

While the comments received by the Department may illustrate disagreement about whether ratepayers are best served by short or long-term contracts for energy supply, we maintain that there is no potential downside for increasing our commitment to energy efficiency through increased programmatic spending and policies such as improved appliance efficiency standards. Energy efficiency is the one policy that can provide great benefits to all ratepayers without changing the dynamics of the supply-side of the electricity market.

In conclusion, we are extremely disappointed that other commenting parties did not address these three fundamental problems in their initial comments. The DTE has the authority and responsibility to protect default service customers from these excessive costs and cross-subsidies, and we strongly urge you to do so, and we provide specific recommendations on specific solutions that would achieve this. By requiring that default service providers meet their RPS obligations by procuring an additional 0.5% of their overall portfolios each year through long-term contracts with renewable energy generators, the DTE could begin to meet its fundamental obligation to protect captive customers from price volatility, and to implement state law in a way that minimizes costs and ensures that those who pay for the costs of renewable energy also derive the price stability benefits.

## **II. Due to the lack of attention by state regulators and default service providers, DTE must make procurement for RPS compliance a priority.**

Our review of the comments of the major default service providers (Massachusetts Electric and Nantucket Electric Companies, NStar, Fitchburg Gas and Electric, and Western Massachusetts Electric Company), the Massachusetts Attorney General (MA AG), and the Massachusetts Division of Energy Resources (DOER) revealed that none of these entities addressed the need for default service providers to procure renewable energy to meet the compliance requirements of the Massachusetts Renewable Portfolio Standard (RPS). We see the lack of attention to RPS procurement obligations by both default service providers and state regulators as extremely shortsighted. This disappointing disregard for a regulatory requirement indicates the necessity for DTE to develop a set of explicit expectations and policies that apply to default service providers with respect to procurement for RPS compliance. Simply put, prudent procurement for RPS compliance is an essential part of default service procurement and must be examined by the Department in this light.

Our main concern stems from the very real dynamic currently developing that will result in *either or both of the following*: (i) insufficient renewable energy being developed due to lack of a sufficient quantity of long-term contracts available in the market to attract capital, and (ii) customers from other states, large commercial and industrial customers, and municipal customers all reaping the benefits of long-term contracts with renewable energy generators. Without such arrangements, the residential and small commercial and industrial (C&I) customers, for whom no meaningful alternatives to default service exist now or for the foreseeable future, will pay top dollar for renewable energy without any of the benefits. We provided recommendations to DTE in our initial comments, and will expand on these in our reply comments below.

**III. A requirement for long-term contracts for renewable energy in default service policies is consistent with DTE's responsibilities.**

We strongly agree with the principle presented by the Massachusetts Attorney General (MA AG) regarding the need for DTE procurement policies to minimize long-term costs to consumers and maintain safe and reliable service (MA AG at 1). We echo the MA AG's support for the need to diversify risk, reduce price volatility, and reduce overall prices through the inclusion of long-term contracts. As described in our initial comments, long-term contracts for renewable energy can deliver such results.

We strongly agree with the observation that default service is likely to be the only service available to the majority of residential and small C&I customers for the foreseeable future (DOER at 4). Therefore, it is our view that the Department should require default service providers for these customer classes to use best available procurement practices that result in stable, fair, and reasonable electricity rates. In our initial comments, we describe the benefits of long-term contracts, in particular for renewable energy, and their role in achieving equitable, stable, and reasonable rates in a setting where most customers are on, and will remain on, default service. We also reiterate here our support for aggressive investment in energy conservation and efficiency by default service providers.

In the future, if market conditions change and the availability of alternatives increases to the point where customers have the opportunity to leave default service, DTE procurement policies can be modified to reflect such a change.

**IV. Long term contracts for renewable energy are well-suited for default service procurement**

As we described in our initial comments, renewable energy facilities have several unique characteristics that make them especially well suited for long-term contracts. These power plants do not rely on fossil fuels, so their forward pricing of energy is tied largely to the amortization of initial capital investment. In contrast, fossil fuel plants must price to account for future long-term fuel price risk in the form of a premium under a long-term arrangement. As a result, a renewable energy generator can offer a stable, lower price over the long term relative to a fossil fuel generator. In our view, the DOER incorrectly characterizes the problems with long-term

contracts (DOER at 10, 11) because it does not consider the unique characteristics that new renewable energy generators seeking financing bring to the marketplace.

We are greatly concerned about the current approach to RPS compliance procurement by regulated utilities for several reasons. Their procurement approach (buying on the spot market or making alternative compliance payments) clearly lacks consideration of the benefits of renewable energy described here and in our initial comments. Further, the lack of long-term commitments to renewable energy, even if limited to the RPS compliance obligation, is imposing undue costs on customers.

Requiring default service providers to enter into long-term contracts for RPS compliance would be in the best interest of the customers. At a minimum, we strongly recommend the Department require that beginning now through 2009, default service providers enter into long-term contracts of at least 10 years to meet the annual incremental rise in their RPS obligation. It would be particularly practical for default service providers to solicit such contracts with sufficient lead-time needed by renewable generators. The gradually increasing RPS compliance targets provide default service providers the ability to account for changes in their obligation due to any customer migration that may occur over time.

We currently do not envision a scenario where the competitive retail market develops in such a way as would result in a default service provider having less than 4% (the RPS target in 2009) of its current load, so the energy procured under such an arrangement would be highly likely to exceed the needs of the default service provider. Also, the certificates procured for RPS compliance are fungible, and could be resold if the default service provider does not require them (i.e. if customers migrate at a much faster rate than they have been).

Finally, on this point, to the extent that the threat of customer migration causes distribution companies concern about buying more long-term renewable energy certificates (RECs) than their targets, there are several possible approaches to mitigate such concerns. At a minimum, we recommend consideration of a prudence test. If the RECs were procured prudently, then the default service provider should be allowed to recover the costs through its rates.

We also believe that the inclusion of a long-term component of default service procurement that matches the RPS compliance target would not significantly impact the overall price signal sent by the default service provider and therefore would not have a direct influence over the market dynamics that would influence the entry of competitive suppliers for these customer classes.

**V. The Department should require the same level of transparency for RPS compliance procurement as for energy procurement**

In its initial comments, the DOER recommends the Department standardize default service procurement so that it is regular, predictable, and transparent (DOER at 3). We agree with this recommendation. Markets work best when timely, accurate information is available to buyers and sellers. However, we wish to expand on this point. We note that the procurement practices of default service providers for RPS compliance is totally lacking in any of the characteristics that DOER supports for energy procurement. We also note that the DOER has yet to release a

report on compliance with the RPS for 2003, although it has had the data for over 6 months. We therefore recommend that the Department develop a set of consistent practices for RPS compliance, available for public scrutiny, which default service providers must abide by.

Default service customers will benefit both from increased regularity, predictability, and transparency in the procurement of renewable energy for RPS compliance, as well as from increasing the accountability of default service providers and providing much needed information to customers and competitive retail and wholesale suppliers. Currently, the lack of information is contributing to market uncertainty, and this uncertainty is contributing to excessive REC prices.

As part of Department action on this recommendation, we specifically call on the DTE to require default service providers to report annually on their RPS compliance plans, including a quantitative demonstration regarding the appropriateness of their compliance approach. Default service providers should also be required to make quarterly progress reports on the number of RECs they have acquired and transferred to their account and the number of RECs for which they have entered into forward contracts. These latter reports are currently generated by the NEPOOL Generation Information System and could easily be available to the public.

**VI. If statewide procurement for default service energy is considered, procurement for RPS compliance should be included**

Several commenters, including DOER, MA AG, Massachusetts Electric, Constellation, and others, voiced initial support for the concept of statewide procurement of energy for residential and small C&I default service customers. We believe there would be both advantages and disadvantages to such an approach and agree with those commenters who recommend careful consideration of the potential costs and benefits of statewide procurement before implementing such an approach.

However, in the event that the Department does implement statewide procurement for default service customers at some point, we would strongly support the inclusion of renewable energy for RPS compliance in this process. Some of the advantages described for statewide default service procurement, especially addressing effects of asymmetrical pricing across service territories and between small and large procuring entities, would also apply to RPS compliance procurement. Such an approach for renewable energy, particularly if is done under long term contracts for both renewable energy and certificates, would maximize the benefits to default service customers. We also recommend that the Department specifically investigate the possibility of including an option for other suppliers such as municipal aggregators to participate in statewide RPS procurement.

As a potential model, we direct the Department's attention to the recently enacted requirements of the Rhode Island Renewable Energy Standard legislation which requires the Public Utility Commission to adopt regulations that include provisions for "standards for contracts and procurement plans for renewable energy resources" (2004 -- S 2082 SUBSTITUTE A, AN ACT RELATING TO PUBLIC UTILITIES AND CARRIERS -- RENEWABLE ENERGY STANDARD, at 39-26-6).

## **VII. Communications**

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